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TAGS: ECON ENRG EPET EINV ES
SUBJECT: PENDING ENERGY SECTOR DISPUTES IN EL SALVADOR

¶1. (U) SUMMARY: The new Funes administration is inheriting several commercial disputes in the energy sector that raise questions about the enforceability of contracts and may discourage new investment in generation projects. Two U.S. firms have contested decisions by a majority-state-owned generation company to cancel long-term energy agreements. Italian firm ENEL is pursuing a $120 million arbitration claim against state-owned generation company, CEL, over the control of a joint geothermal venture. Another generator, Nejapa Power, is pursuing its third arbitration case against CEL relating to the cancellation of a long-term power contract. U.S.-based AES has appealed a competition agency fine for allegedly blocking entry of other energy distributors. Incoming Treasury Minister Carlos Caceres admits that the GOES does not have a winning arbitration record and the change in government could provide an opportunity to negotiate solutions to some or all of these disputes. END SUMMARY.

BAIT-AND-SWITCH INVESTMENT PROMOTION

¶2. (U) In 2008, two U.S. firms contested decisions by a majority-state-owned generation company, LaGeo, to cancel long-term energy agreements. Garment manufacturer, Hanes Brand, successfully restored its original agreement after reportedly threatening to relocate. Kimberly Clark, is still pressing the GOES to restore its energy contract and has threatened to shift the planned construction of a $32 million paper mill to Costa Rica if the contract is not restored.

¶3. (SBU) Hanes received two letters-of-intent from LaGeo in 2007, establishing a fixed-price energy contract for Hanes, planned fabric factory. In April 2008, after Hanes had committed to this investment, newly installed LaGeo President Napoleon Guerrero (who is also president of the Salvadoran Industrial Association) ASI) cancelled the agreement with Hanes. Hanes lobbied for six months and threatened to shut down operations in El Salvador if the energy agreement was not restored. According to company managers, LaGeo finally honored the agreement only after President Saca "twisted Napoleon Guerrero,s arm."

¶4. (U) Kimberly Clark signed a long-term energy contract with power distributor Excelergy, linked to Excelergy,s long-term contract with LaGeo. LaGeo abruptly cancelled Excelergy,s three-year energy contract in April 2008, claiming that its "new commercial policy" would not allow it to support the rate structure in Excelergy,s contract. Excelergy then cancelled its contract with Kimberly Clark that would have locked in electricity prices through 2010.

¶5. (U) Kimberly Clark,s Country Manager Ruben Melara said the cancelled energy contract was a critical factor in the company,s decision to plan a $32 million expansion project

in El Salvador. He noted that without the energy contract in El Salvador, they would have chosen Costa Rica for the project. During an early 2009 visit to El Salvador, Kimberly Clark,s regional manager asked Melara to see if escape clauses in its procurement and construction contracts would allow them to cancel the Salvadoran project if the energy contract is not renewed.

¶6. (SBU) At a December 3 ceremony to announce construction of Kimberly Clark,s new paper mill, President Saca directed his personal secretary Elmer Charlaix to work on resolving the dispute. An initial meeting with Charlaix was followed by weeks of unreturned phone calls. Melara met again with Saca who then asked his Chief of Staff, Eduardo Ayala, to look into the case, with the same unsuccessful result. LaGeo claims ENEL will not allow the contract, but ENEL told Econoff it had no objections to LaGeo,s long-term contracts.

ENEL ARBITRATION CASE

¶7. (U) ENEL requested arbitration in October 2008 to resolve a dispute with state-owned electric generator, CEL. ENEL is demanding $120 million in compensation for CEL,s alleged failure to comply with a contract that would allow ENEL to gain a majority stake in LaGeo to reflect its capital investment. ENEL is reportedly offering to invest $108 million to increase LaGeo,s generation capacity if it is allowed to gain a controlling interest.

¶8. (SBU) CEL President Nicolas Salume has publicly argued that geothermal energy is a strategic resource that should remain under CEL,s control. One CEL board member told Econoff the joint venture agreement specified a minority ownership share for ENEL,s initial investment, but it did not commit to a comparable ownership stake for subsequent investments. He acknowledged that CEL,s reliance on LaGeo dividends to help pay electricity subsidies may have influenced CEL to maintain control of LaGeo. ENEL,s representative to CEL,s board told Econoff that CEL managers simply want to maintain control of LaGeo in clear violation of ENEL,s contract. The case is in early stages of the arbitration process.

AES, COMPETITION CASE STILL PENDING

¶9. (U) U.S.-based AES, El Salvador,s largest electricity distribution company, is awaiting the resolution of a competition case pending before the Supreme Court. AES appealed a $247,000 fine by the competition agency for allegedly blocking the entry of another firm into the energy distribution market. AES claims it was following a legal requirement for companies to publish an approved tariff schedule before they can distribute electricity. Distribution companies have also complained that El Salvador allows small companies to enter the distribution market and cherry-pick more favorable areas without equitably sharing service requirements for less accessible (and more costly) areas. The Supreme Court has no time limit to decide on the case.

NEJAPA ARBITRATION

¶10. (U) A formerly U.S.-owned generator, Nejapa Power, now owned by an Israeli consortium, is pursuing its third arbitration case against CEL, arising from CEL,s effort beginning in 1999 to terminate a long-term energy contract with Nejapa Power. After winning judgments of $90 million and $84 million in the first two cases, Nejapa is trying to recover $25 million for taxes collected on its previous claims. With a ruling expected by August, Nejapa managers are confident that they will prevail in what they call the most "clear-cut" of their three cases with CEL.

COMMENT:

¶11. (SBU) It is ironic that the head of El Salvador,s industry association (ASI) played a major role in canceling energy contracts for two leading industrial firms. In the short term, failure to resolve ENEL,s claims will delay investments to expand LaGeo,s generation capacity and postpone its greater energy independence. Geothermal generation (second to hydroelectric power in generation efficiency) accounts for about 25 percent of electricity generation and could provide half of El Salvador,s electricity needs, reducing its reliance on fossil fuel imports. However, geothermal resources will not be fully utilized unless the GOES can develop it, and that will not happen as long as the GOES continues to force companies to seek legal action to enforce their rights.

¶12. (SBU) With arbitration claims approaching $150 million, CEL is financially vulnerable at a time when the company is still recovering from carrying the burden of subsidy payments. Incoming Minister of Hacienda (Treasury) Carlos Caceres told EconCouns that he is worried about the arbitration cases, as El Salvador "does not have the best record at winning those cases." Already weakened by subsidy costs and a possible recession, the new government might be more inclined to settle these claims. It would send a positive message to investors and help to attract investment to best meet El Salvador's future energy needs.
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